

DOCUMENT RESUME

ED 276 364

HE 019 863

AUTHOR Case, Karl E.
TITLE The Office of Family Finance and Planning (Formerly the Financial Aid Office).
PUB DATE Nov 86
NOTE 5p.
PUB TYPE Journal Articles (080) -- Viewpoints (120)
JOURNAL CIT AAHE Bulletin; p8-11 Nov 1986

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS *College Students; Family Income; Higher Education; Information Needs; Interest (Finance); *Long Range Planning; *Need Analysis (Student Financial Aid); *Parent Financial Contribution; *Student Costs; *Student Financial Aid Officers

IDENTIFIERS *Paying for College

ABSTRACT

The need for advance planning to finance college studies is addressed. It is suggested that financial aid officers should stop thinking about this year's family income and current assets as a pool of resources to be tapped to pay for this year's parental contribution to college costs. Instead, income and assets might be viewed as indicators of a household's long-term ability to finance a major purchase. An example of a discussion that an aid officer might have with a parent using the current logic of the "Financial Aid Form Needs Analysis Report" is presented. The conversation presents two problems: (1) it takes place 6 months before college entry when the parent looks for help from the college, and (2) only this year's income and parent contribution are discussed. An alternative conversation that might take place could inform the parent that: paying over more years makes the payment lower; deciding to pay early will result in interest; and compounding interests can yield large gains. Tables provide a family financial profile and alternative ways to pay for college. It is recommended that a college assemble information on borrowing options open to parents and that talks be given to parents as early as the child's elementary and junior high years. Computer software can help determine monthly payments that will cover future college expenses. (SW)

* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *

THE OFFICE OF FAMILY FINANCE AND PLANNING

(Formerly the Financial Aid Office)

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
EDUCATIONAL RESOURCES INFORMATION
CENTER (ERIC)

☐ This document has been reproduced as
received from the person or organization
originating it.

☒ Minor changes have been made to improve
reproduction quality.

• Points of view or opinions stated in this docu-
ment do not necessarily represent official
OEI position or policy.

by Karl E. Case

"PERMISSION TO REPRODUCE THIS
MATERIAL HAS BEEN GRANTED BY

AAHE

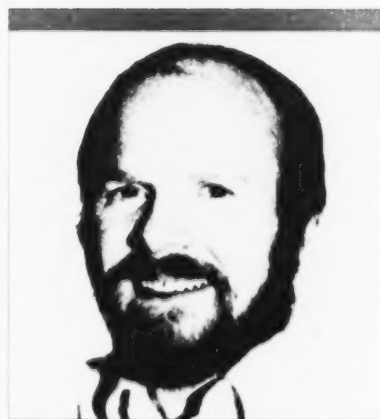
TO THE EDUCATIONAL RESOURCES
INFORMATION CENTER (ERIC)."

Five years from now, a sign with words similar to the title of this article will hang on the doors of many old "financial aid offices." Change is coming to the college finance business and when it does, it's going to be a very good thing for higher education. People will have more information and will make better choices about whether to go to college, where to go to college, and how to pay for it.

There is a funny paradox in today's financial aid office. The director knows more about the intricacies of long-term personal financial planning than anyone else in the administration. But that knowledge is rarely used to help the college or families plan. Its use is confined to that fraction of students and families defined as "needy," and to figure out what they're up to at the moment.

Today, financial aid directors know about IRA's and Keoughs. They are becoming aware of other kinds of tax deferred savings programs, such as 403b and 401k plans. Many struggle with the complexities of tax shelters or with the returns of incorporated doctors. More and more aid administrators find themselves forced to exercise professional judgment in needs analysis. Without much formal training, many have become the functional equivalent of tax lawyers.

All of this information is applied to one limited task, that of generating a "fair" parental contribution (PC). That is a difficult task, and, for the most



Karl (Chip) Case is visiting scholar with the Federal Reserve Bank of Boston and associate professor of economics at Wellesley College.

part, aid officers and the uniform methodology (UM) do a fantastic job. Unfortunately, the UM stops with PC and implicitly assumes the most illogical of all possible arrangements for financing: paying for a year's educa-

tion out of a year's income. Most aid officers I know still think of this year's income and current assets as a pool of resources to be tapped to pay for this year's PC. We should instead think of them as indicators of a household's long-term ability to finance a major purchase.

A college education is a major investment in an asset that will presumably yield dividends to parents and students over a long period of time. For all the other major assets we purchase in our lives we are somehow comfortable with the idea of planning and long-term financing.

When you ask yourself whether you can afford a house, you immediately think in a 25- or 30-year time frame; the first thing you want to know is the mortgage rate and the monthly payment. Car dealers have switched from direct rebates and discounts to sweet financing deals because they find them more effective. When you get right down to it, higher education is probably the *only* industry in the U.S. that sells a big-ticket item without offering across-

When you get right down to it, higher education is probably the *only* industry in the U.S. that sells a big-ticket item without offering across-the-board assistance with financing.

the-board assistance with financing.

My argument is that colleges, led by their financial aid directors, have the opportunity to plug a very big hole. The provision of basic help with financial planning to families can be done easily and cheaply. You wouldn't have to change need-based methodologies, though you might want to. You wouldn't necessarily have to use institutional resources. You already know enough to be very helpful to families: the basic logic of planning is quite simple.

The potential gains are great. First, you would be providing parents much better information on real costs and affordability. There is a great deal of misunderstanding out there about college costs, and it is *not* confined to the aid population. (Sometimes I think aid recipients know more than the people paying full freight.) Better information will, without question, lead to better choices, and we all benefit.

By encouraging planning, colleges over the long haul could significantly increase parental saving, and thereby reduce today's runaway need for college-provided aid. And, without question, setting contexts for families can enhance the face validity of the current needs-analysis system.

To illustrate all of this I want to begin with a conversation that an aid administrator might have with a parent using the *current* logic of the famous "Financial Aid Form Needs Analysis Report" (FAFNR). Then I want to try some alternative discussions that the same aid administrator might have with the same parent if the window of time were opened a bit wider.

Table 1 presents information on the family of O.T. Lunch, assistant general manager of the Pawtucket Red Sox, a minor league ball team, living in Providence, Rhode Island. From a needs analysis standpoint, O.T. is an easy case. His income is

straight salary with some interest in bonds. He lives in a home worth \$140,000 that he bought three years ago for \$90,000. He refinanced his \$80,000 mortgage two years ago at 12.5%. He has a nice pension accumulation of \$25,000 in an IRA, but we don't touch that—yet.

When you add it up, Mr. Lunch has net assets of \$70,000, minus an Asset Protection Allowance (APA) of \$31,500, or \$38,500. That produces an income supplement of \$4,620. On the income side there is nothing complicated: \$55,000, after we add back the marital deduction and his IRA contri-

bution, minus taxes leaves \$35,408 or \$2,950 per month.

To calculate his PC, we knock off a Standard Maintenance Allowance (SMA) of \$12,500, add the income supplement from assets of \$4,620, and head for the UM's tax tables. Result: O.T. Lunch's parental contribution will be \$10,020. He heads for the Aid Office!

"You've got to be putting me on! You expect me to lay out ten grand to send my kid to this college? You think because I earn \$55,000 I'm rich? You obviously don't know how much it takes to live around here! And by

TABLE 1

**O.T. LUNCH
FAMILY PROFILE**
(4 persons, 1 in college)

INCOME		ASSETS	
Total Income	\$55,000	Home Value	\$140,000
Taxes		Mortgage	-80,000
FICA	-2,792	Net Equity	60,000
Federal	-11,300	IRA	25,000
State/local	-5,500	Stocks/Bond	+ 10,000
After-Tax Income	\$35,408		70,000
Income Supplement	+ 4,620	APA	-31,500
SMA	-12,540		38,500
AAI	\$27,488	Inc. Rate	× .12
		Supplement	\$4,620

Parental Contribution: \$10,020

MONTHLY EXPENSES

Mortgage Payment	
(80,000@ 12.5)	\$827.00
Electricity	110.00
Car Payment	247.00
Food	675.00
Heat	160.00
Phone	65.00
Car Insurance	55.00
Homeowners Ins.	84.00
Health Insurance	105.00
Life Insurance	192.00
	\$2,565.00

Monthly After Tax Income: \$2950.00
PC/12 = \$846.66
PC/Monthly After Tax Income = 28.7%
Income Net of Expenses = \$385
IRA contribution: \$333 (\$4000/yr)

Colleges, led by their financial aid directors, have the opportunity to plug a very big hole. And the potential gains are great.

the way, I read your literature. It said you 'meet need' ... I've got half a notion to sue you for false advertising. Here's a list of the bills that I have to pay ... it leaves \$385 a month, and my IRA contribution is

lower-cost alternative for his daughter.

Presidents and deans should know that this conversation occurs dozens of times a year in their aid office, with a whole range of endings, many

If she goes public, it will probably be less, but it's hard to tell; states are getting squeezed.

"I know that you're not rich, and that \$40,000 sounds like a ton ... but how does \$192 a month sound to you? That's 25% less than the payment on your Toyota, and its just 6.5% of your take-home pay. If you delay, college will cost you a third of your income. Also, with a bit of help, we can easily get it down to \$168 a month, even with the recent changes in tax law."

I realize that you're not going to get to most folks when their kids are in the fourth or fifth grade. There are big gains even if you can get them thinking two or three years early. But suppose you don't, and they end up like O.T. Lunch in your office. Then you're no worse off than a real estate broker pushing a \$100,000 house. You need to extend the financing horizon into the future, and you know a lot about that. Many of you do that already; I've seen some wonderful brochures on parent borrowing options. Even with a 12.5% loan, you can cut O.T.'s payment load in half. The SHARE program of the Consortium on Financing Higher Education offers parents longer-term loans; its current rate is 9.5%.

Let me go back and explain where I got the figures of \$192 and \$168 a month. As I walk through it, there will be absolutely nothing complicated. There is this incredible myth that financial planning takes a law degree, an MBA, and years of experience. Baloney.

There are three things that you need to know: (1) if you pay over more years, your payment is lower; (2) if you decide to pay early, you will earn some interest to help; (3) compound interest can yield surprisingly large gains—8% compounded annually doubles your money in nine years.

Table 2 shows how \$192 per month can generate \$40,000 if you start eight years early. I've assumed

TABLE 2
STARTING EIGHT YEARS EARLY
Assumptions: Interest on savings 5.3% (8% Taxable)
Parents can borrow at 12.4% (8.25% after tax)

YEAR	MONTHLY PAYMENT	ANNUAL PAYMENT	COLLEGE PAYMENT	INTEREST	BALANCE
1	192	2304	—	122.11	2426.11
2	192	2304	—	250.69	4980.81
3	192	2304	—	386.09	7670.90
4	192	2304	—	528.67	10503.57
5	192	2304	—	678.80	13486.37
6	192	2304	—	836.88	16627.26
7	192	2304	—	1003.36	19934.62
8	192	2304	—	1178.65	23417.26
9 College	192	2304	10,000	833.23	16554.49
10 College	192	2304	10,000	469.50	9327.99
11 College	192	2304	10,000	86.49	1718.49
12 College	192	2304	10,000	-493.14	-6470.65
13	192	2304	—	-333.33	-4499.99
14	192	2304	—	-175.67	-2371.66
15	197	2371	—	—	0

\$333 a month. You tell me where I'm going to get my hands on \$10,000 a year for four years."

What do you say? "Well sir, let me explain our methodology for determining need. First, we subtract taxes, including an estimate for state and local taxes. Then we subtract what we call the Standard Maintenance Allowance (SMA) which in your case was \$12,500. ..."

"Hold it right there ... you mean to tell me that you are giving me a 'maintenance allowance' of \$12,500? If I sold my house, I couldn't find an apartment and heat it for that!"

The aid officer is clever and explains that no one is expected to live on the SMA; that's just the point at which we expect parents to begin contributing something ... at which point O.T. begins to think about a

unfavorable to the college. There are two problems with this conversation: (1) it doesn't take place until O.T. looks for help from the college, six months before classes start, and (2) the whole conversation is confined to *this year* ... both parties are talking about this year's PC and this year's income.

Think now of the conversation your college might have had with the same guy eight years earlier:

"Your daughter is now in the fourth grade, and she is clearly brilliant. She's going to want to go to college and you are going to have to pay a good part of the freight. Looking over your finances, I would guess, and this must be a rough guess, you'll have to come up with about \$10,000 a year for the four years she is in school, if she wants to go to a private

don't think it would take much to prompt planning that would generate some real benefits. The first step is to start thinking differently.

that the person simply puts savings into a bond or CD at 8% taxable or 5.3% after tax. The table figures interest on the balance after the payment is made at 5.3%. At the end of eight years, the family has \$23,417. That's a

I figured the interest on the savings at 8% instead of 5.3%. There are several ways to do that. The most common is to put the money in the kid's name and have the interest taxed at the kid's rate (i.e. zero). That can be

The first step is to start thinking differently. Within the aid office, we have to break the limitation of thinking about this year's income and assets as the pool of resources to tax. It is better to think of it as an *index* of the family's ability to sustain an effort over some finite time horizon. That doesn't mean you have to assume anything about the past.

Second, a college needs to assemble information on borrowing options open to parents. Your institution need not necessarily sponsor or even participate in them; there are many sources of private and public credit. But let parents know the options and eligibility requirements.

Third, there are big gains to be realized if you get to parents early. School counselors, for some reason, seem to talk to admissions folks and not aid administrators. We already have some literature on planning for college costs; we should have more and should get it to parents earlier. We should be out giving talks to PTA's in elementary and junior high schools.

There may be ways of identifying potential young applicants early. Alumni networks might be helpful. If a school has a strong regional identification or draws most of its students from a particular area, you may want to go beyond the PTA.

Fourth, there is new software available that asks you for your child's age, assumptions about inflation, expected tuition interest rates, and so forth, and spits out a nice flat, monthly payment sufficient to get your child through college. I suspect it will be widely distributed within a year. I hope you'll use it.

Fifth, your new Office of Family Finance and Planning will reach out to a broader clientele. It no longer will do to talk just to people who apply for aid or who end up with a PC less than your budget; *all* families, including those who would otherwise not even apply to your college, become the necessary target of this essential new service. ■

TABLE 3

WAYS TO PAY

Assumptions: After Tax Income \$35,408 (\$2950/Monthly)

PC 86/87 10,000

Marginal Tax Rate .33

Household can borrow at 12.4%

Household can invest at 8% Taxable
or 5.3% Tax Free

	Monthly Payments	Payment as % of Income	Years over which Financed:		
			Pre Col.	During	Post Col.
Pay out of current income	\$833	28.2%	0	4	0
Borrow	\$436	14.8%	0	4	10
Save and Borrow (Savings Acct)	\$192	6.5%	8	4	3
Save and Borrow (Trust)	\$168	5.7%	8	4	3

conservative figure; it only figures annual compounding. A good investor should be able to get more than 5.3%.

At the end, this family ends up with a \$6500 loan at 12.4%, paid off in three years. Clearly, by accepting a bigger debt at the end, the monthly payment would be even lower. No tricks ... no MBA ... extend the time and the payment becomes affordable.

Table 3 gives real meaning to the terms "affordable" and "ability to pay." I don't know what it means to afford a \$40,000 education, any more than I know what it means to afford a \$100,000 house. But I *can* think clearly about whether I can afford a payment of \$436 a month. Table 3 also shows how important the time dimension is: 28% of income is not the same as 5.7%.

Briefly, the only difference between the \$192 and the \$168 is that

done with no legal help under the Uniform Gifts to Minors Act. You simply invest the money in Jr.'s name and act on his behalf until he reaches majority.

This is unaffected by the new tax law. Under the new law, if a child earns more than \$1,000 in interest, the excess will be taxed at her parents' marginal rate until she is 14. Notice on Table 2 that if you start saving when your child is 10, she won't be earning over \$1,000 in interest until she is 16. Thus, she will never have to pay any tax.

My point, again, is that you don't have to get fancy. To go from 28% of income down to 5.7% of income takes no legal help at all.

As I've argued, I don't think it would take much to prompt planning that would generate some real benefits.